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DEPT FOR EAP/MTS AND EB/IFD/OMA  
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SINGAPORE FOR SUSAN BAKER  
COMMERCE FOR 4430-JEAN KELLY  
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SUBJECT: INDONESIA TO RAISE FUEL PRICES TO SOOTH MARKETS

**¶11.** (SBU) Summary: President Yudhoyono is set to approve a 25% fuel price increase at a Cabinet meeting next Monday, according to the Ministry of Finance (MOF). The Government of Indonesia (GOI) wants to demonstrate its commitment to fiscal sustainability in light of high oil prices, a rising subsidy bill, and a flagging macroeconomic outlook. To reduce negative domestic reactions, the GOI will implement a cash transfer program for poor households to offset the economic costs of the fuel price increase. The fuel price increase, scheduled for June, is largely optics for financial markets as the subsidy and overall budget savings are minimal. Long-term macroeconomic challenges remain, particularly with rising inflation projections. End Summary.

President to Approve Fuel Price Increase on May 5

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**¶12.** (SBU) President Yudhoyono has informally approved a 25% fuel price increase, but will convene a Cabinet meeting on May 5 to officially sign off on the plan, according to MOF Fiscal Policy head Anggito Abimanyu. The price hike will increase regular gas (called "Premium") from Rp 4,500 (\$0.50; Rp 9,000/USD) to Rp 6,000 (\$0.67) per liter, still below international market rates of Rp 8,000 (\$0.89) per liter. The lowest cost gas (called "Solar") will increase from Rp 4,300 (\$0.48) to Rp 5,500 (\$0.61) per liter. The higher quality, unsubsidized gas (called "Pertamax") will remain at Rp 8,300 (\$0.92) per liter. Kerosene will also increase 25%, from Rp 2,000 (\$0.23) to Rp 2,500 (\$0.28) per liter.

**¶13.** (SBU) The actual budget savings based on this fuel price increase is minimal. The fuel price increase will reduce the GOI's subsidy bill by Rp 25 trillion (\$2.78 billion), roughly 10% of the overall subsidy bill and 2.5% of the entire budget. However, the GOI will use about 50% (Rp 11.5 trillion; \$1.28 billion) of the savings for a cash transfer program. Beginning in June, the GOI will disburse Rp 100,000 (\$11.11) to poor households every three months. The GOI wants to present this fiscal policy decision as pro-poor to counter potential domestic criticisms that fiscal policy improvements are made at the expense of the poor.

Fuel Price Increase: Largely Optics for Markets

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**¶14.** (SBU) The GOI hopes to assuage the financial markets with the fuel price increase, according to Abimanyu. The fuel price hike

will buy the GOI a short reprieve from market scrutiny, but will not fundamentally alter long-term fiscal challenges and risk assessments, according to MOF and private bank contacts. High oil prices, a rising subsidy bill, and high inflation have led to increasing financial market uncertainty, particularly in the past four months. Financial markets have been waiting for this fiscal policy move. Investor concerns have driven 10 year yields on government bonds to 13%, up from 10% in January 2008. The fuel price increase should improve market perceptions, but it also leaves one large problem: inflation. The MOF estimates inflation to be 11.1% this year (6.5% core inflation; 2.5% volatile commodity prices; 2.1% administered/fuel price increase). Financial markets will now look to the central bank to begin raising interest rates to reign in inflation.

#### Long-Term Fiscal Outlook Still in Question

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**¶5.** (SBU) The GOI is still considering additional long-term fiscal sustainability measures. GOI officials are evaluating an overall cap on fuel subsidies that would limit the fuel subsidy bill to three percent of GDP, roughly Rp 132 trillion (\$14.67 billion). Although MOF officials claimed that this cap was already in place, there is no provision in the budget law yet, according to a senior Parliament Budget Committee contact. Capping the subsidy bill would have an even more positive effect on markets due to countering perceptions of an unlimited subsidy bill, according to World Bank Jakarta's lead economist Bill Wallace. Regardless, the GOI will likely overshoot this "three percent" subsidy rule this year, according to Abimanyu.

**¶6.** (SBU) The MOF is proposing an automatic price adjustment mechanism for fuel as a long-term strategy to reduce subsidies. Abimanyu suggested a monthly Rp 500 (\$0.06) or Rp 1,000 (\$0.11) per

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liter increase to gradually move fuel prices to international market rates. However, he said that this proposal was in its preliminary stages. The MOF is also implementing a pilot project on fuel "smart cards," which would limit fuel consumption per person. The pilot project will be limited initially to two cities (Denpasar, Bali and Batam); nationwide implementation is not expected in the near term.

#### Protests, Political Implications of Fuel Price Hike

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**¶7.** (SBU) The GOI is anticipating some political economic fallout from this fuel price hike, but is taking action to limit negative reactions, according to our contacts. The intensity of this reaction is uncertain. In 2003, the Megawati administration reversed their original fuel price increase due to violent protests. In 2005, the 125% fuel price increase led to strong, but manageable protests. Inflation stabilized within six months of the 2005 fuel price increase. The current cash transfer program is designed to dampen any potential public backlash, according to Abimanyu. In addition, the GOI is leaking the fuel price increase proposal to test the waters for possible protests and financial market reactions ahead of next week's Cabinet meeting to announce the fuel price increase. Due to wide political support for the fuel price increase, protests are likely to be minimal, according to our contacts.

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